

## **Transcript of Conference Call - A Panel Discussion:**

### **Troubled Company, Workout and Bankruptcy Issues *A little "gloom and doom" with your morning Java***

**Chapter Meeting of the Twin Cities Chapter of NASPP  
Thursday, September 18, 2008, 8:00 a.m. – 9:00 a.m. Central Time**

#### **Topics:**

Short and long-term compensation in a downturn situation

Underwater stock options, morale issues and communications strategies

Executive separation agreements, interim executives, and protecting the company in hiring new executives

Workout and Chapter 11 issues – retention agreements, treatment of benefit programs, and dealing with creditors

Q&A and Roundtable Discussion

**Course materials are attached.**

#### **Panel Members [see attached biographies]:**

**Michael L. Meyer** of Ravich Meyer Kirkman McGrath Nauman & Tansey, P.A. – an attorney who concentrates his practice on workout and bankruptcy situations.

**Scott Feraro** and **Kathy Bonneville** of Seabury OCI Advisors, LLC – Compensation consultants with active practices in the Twin Cities area.

**Martin R. Rosenbaum** of Maslon Edelman Borman & Brand LLP, Moderator

#### **Partial Transcript:**

**Marty Rosenbaum:** We've all been glued to the news of what I'd say is an unprecedented, at least for a long time, series of ripples in the financial markets. I don't think any of us quite knows where it's going to stop. But, as of a couple days ago, the big one was Lehman Brothers. We may be out of touch already, just because we're not dealing with AIG, which was the big news from yesterday. But I looked back at Lehman Brothers' proxy statement, from six months ago, just to set the stage. Talking about their CD&A disclosure – a lot of language in different companies' proxy statements looks very similar. But theirs talks specifically about having a significant portion of compensation in equity-based awards, thereby further aligning the financial interests of employees with those of stockholders and, I quote, "encouraging prudent long-term strategic decisions and risk management." And, of course, hindsight is wonderful, and I don't think any of the experts anticipated such a rapid collapse of parts of the financial system. Still, the Compensation Committee was clearly trying to reward risk management behavior, and clearly something went wrong. So I guess I'd ask the panelists, maybe starting with you, Mike, if you could give us some perspective on the Lehman bankruptcy and maybe the position the comp committee was in.

**Mike Meyer:** First of all, the Lehman Brothers' bankruptcy is one of the largest, if not the largest, that we've seen, which in and of itself sends huge ripples through the business community. What is unclear to us right now with respect to that case is exactly what the course of it is going to be, in terms of the business plan for the remainder of the business after the Barclays transaction is completed. As everybody has been reading in the paper, the good parts of the Lehman Brothers business are being sold to Barclays Bank, and there will be a job to do with respect to the less desirable parts of the business in Lehman Brothers. How the compensation of management is structured, and how management is incentivized to complete that process with the best possible result, is going to be an important point going forward. I think that it is unlikely that existing compensation structures are going to be addressing the sorts of issues that the board is going to have to look at in those cases, simply because the circumstances that the company finds itself in right now are totally unanticipated.

**Rosenbaum:** Okay, Kathy, anything to add?

**Kathy Bonneville:** Well, with regard to whether or not the compensation program played a role in this, I know there's been a lot of debate among compensation experts and in the community at large about stock options and what sort of behavior that that drives. And there's certainly been a lot of pressure from shareholders who feel like stock option grants, at least a level of grants, has maybe contributed to this risk-taking behavior because the payouts are so huge and unlike with actual shares of stock, there's no downside risk. So, I think there's certainly been a change in the last few years in the size of these grants, and you're seeing a lot of companies already shifting equity compensation to full value awards in much smaller amount. And I think you'll see that trend continuing.

**Rosenbaum:** Why don't we turn to the bankruptcy situation and also bailouts. These are special situations. There's a real shift when a company decides to file Chapter 11, and when it gets close, there are some decisions to be made. We've included in the materials a little summary that Seabury put together about some of the Bankruptcy Code limitations on executive compensation, in particular, under the bankruptcy reform laws that were passed in 2005. Regarding bailouts, we've also included as a separate attachment a recent Wall Street Journal article on the Fannie Mae and Freddie Mac bailouts, and legislation that lets regulators limit compensation to outgoing executives under severance agreements in the home loan industry. But in the bankruptcy situation specifically, Kathy, maybe I'll ask you to briefly go over the limitations on executive pay under 503(c) of the Bankruptcy Code, and maybe explain something I had to be educated about: what are "KERPs"?

**Bonneville:** KERPs – Key Employee Retention Plans – are a pretty prevalent retention device used by companies in Chapter 11 to keep their top talent during a very uncertain time. Typically, a KERP is just oriented around retention and, in the past anyway, there really hasn't been a performance element. If you stay for a certain period you will receive this payment, and it's a cash payment. But the Bankruptcy Abuse Prevention Act that was signed into law in 2005 really has had a tremendous impact on the use of both retention plans and severance in Chapter 11 companies. The reason for the law, I think, was really to protect the creditors and employees below the officer level from the company abusing Chapter 11 protection and paying out a lot of compensation to the executives. I have really seen an impact on the use of retention and severance. I think the requirements are so onerous that with regard to KERPs, retention and severance provisions have pretty much disappeared. In their place, companies in the Bankruptcy Court have approved plans that had a performance piece to them. So it's really not just payments based on sticking around, but the company has to perform. With regard to severance, what companies have ended up doing is, if they want to meet the terms of the Act, then they've put in broad-based severance plans. But still, there's a limit on the amount that you can pay out under these plans that has really had an impact. I don't know, Mike, if you want to comment on that.

**Meyer:** Sure. The bankruptcy reform act that passed in 2005 was called the Bankruptcy Abuse and Prevention Act, which is indicative of the emotions that were going on in Congress at the time this was passed. If you will recall, just as an aside, it included restrictions on consumer bankruptcies and the qualifications that people needed to satisfy to become eligible to go through bankruptcy and get discharged with respect to their obligations. That Act is generally regarded as an overreaction by Congress to situations of perceived abuse that really didn't exist. And this area of executive compensation, I think, is a good example of that. By and large, we had gotten into the mode in the 1990s and the early 2000s of going in to the Bankruptcy Court relatively early on in Chapter 11 cases to get court approval of KERPs. By and large they were justified, because in many Chapter 11 cases you don't know where you're going with the case in the biggest sense. That is to say, you may be moving toward a sale, a complete change in control, typically a sale of the assets of the business as a going concern, and it is critically important to keep the going concern value of the business maintained in order to maximize the result for creditors. As an alternative, you may be going toward a reorganization plan where there's a new capital infusion into the company and a restructuring of the balance sheet. But many times at the beginning of the case, you don't know where you're going, but you need your critical players in management in order to execute the business plan. KERPs were a standard methodology to get that done, and as Kathy pointed out, we're now confronted with an interesting problem at the beginning of these cases, which is how to construct a compensation plan for management to achieve the same objective but not have it be a retention or severance plan, because the restrictions on getting those approved are so difficult.

**Bonneville:** And I would say that has had an impact on companies even outside of companies under Chapter 11. For other companies in turnaround situations, I think boards are reluctant, because of all the attention on KERPs, to put in place retention plans that don't have a performance component. That doesn't mean that you can't design a plan to retain executives, an effective plan. I think one of the most difficult things to do to make it performance driven is, that during a turnaround situation, predicting financial performance can be very difficult. I had a conversation just this week with one of my clients who was looking to try to put a plan in place. They do have other incentive plans - they have an annual incentive plan, but like most annual incentive plans, it's tied to profitability. And in a turnaround situation, the likelihood that that plan will pay out is low. Likewise, they have a lot of long-term incentives in place - but equity, again, is not likely to have value in the short- to mid-term. So, they are in a situation of trying to put something in place for that time period, 18 to 24 months while they're turning around the company. And that is where it's critical to come up with performance measures that will reward them for the turnaround, but something that's achievable that will retain the executives. What we encourage companies to do and, I think, boards are often reluctant to do, is include measures that aren't just financial measures. But if you look at what's critical, often the strategic initiatives required to turn the company around will require significant capital investment, such as investment in information technology, equipment or real estate. Achieving these critical objectives would likely have a negative impact on profitability in the short-term. So, we encourage these clients to focus on rewarding the successful achievement of the strategic objectives during the turnaround.

**Rosenbaum:** So, Kathy, you've touched on a lot of the link between what's going on in the bankruptcy situation and what companies have to think about going forward, and I would assume, Scott, in the financial services industry this whole sort of dichotomy, between things that are going to create a profit now and things that are going to benefit the company long term, is going to be top of mind.

**Feraro:** Well it is, we're approaching things from a preventative standpoint. It is critical to ensure that when an organization finds itself in distress, that they are able to leverage what they had in place initially to proceed through either a difficult time or going in or coming out of bankruptcy. The bankruptcy regulations are specific in that they look at the leverage of legacy plans, as a positive when instituting non-retention-based plans to come out of that bankruptcy situation. So, if you have a performance plan in place that is not viewed as a retention-only plan, changing the metrics and drivers to represent goals that need to be achieved either around cash flow, for instance, or some other driver in a troubled time, that's looked at as a positive and when attempting to achieve post-bankruptcy objectives.

**Rosenbaum:** That leads back to the Lehman Brothers situation, in reading the proxy statement, where it said, we really encourage risk management and we give an incentive. Not to pick on the compensation committee there - again, I'm not sure that anyone could have predicted what was going to happen - but it was interesting to see that what they selected to give people an incentive for risk management was just long-term equity awards, stock options, etc. There wasn't the same direct tie that you get with the annual incentive program where there's a formula, or there's a metric based on someone's judgment of how the company is doing today and maybe this will have an impact going forward for the financial services industry or other industries. If there had been some sort of a judgment or a metric of risk management, what's the company's tolerance for risk in a dire situation. I think in the Lehman Brothers' category we were talking about earlier this morning, it's maybe like building the levee for a 100-year flood, and I think they got a 500-year flood in the financial services markets just in the last few weeks. But if there were a metric on, maybe not the annual incentive program but some other program where at least there was a judgment of risk management at least that would send a signal to management that we're not just paying lip service to risk management. We're actually directly tying a piece of your compensation to it, not just hoping that the fact that the stock will go down if there's bad risk management, will make you play it safer. So it's that direct tie that I think people are trying to put in place for things like earnings, cash flow, return on investment, whatever, but, as Scott said, there are some things that are fuzzier and it's harder to create a metric for.

**Feraro:** Well that idea of decision making and risk has been all over the news in the last few days for sure, but specifically after the Lehman failure you heard a lot of talk about actually tying these rewards to risk and the decisions that are made that put the financial institutions into this place. For example, writing

certain kinds of loans, approving certain kinds of investments that limit the ability for the institution to cover those risks. The idea also that when you're in a troubled situation or in a bankruptcy, the insiders or the senior executives that got you into that situation are the ones that are in place that you're hoping to help get you out. So what decisions are you making around talent and who is in place to help turn you around or get you out of the bankruptcy or troubled situation. That may look very different than the landscape that got you in.

**Rosenbaum:** Yeah, absolutely. Well let's get back to bankruptcy for a minute and, in fact, we have the first question, first live question, from someone on the conference call and I'm going to direct this to Mike and the others. The person asking the question has heard that KERPs are becoming less popular in general, and those that offer them, they've heard, are starting to put an expiration date after two or three years. Is that what the panel members are seeing?

**Meyer:** From my perspective, when somebody comes to see me, whether it be for the purpose of filing Chapter 11 or an out-of-court workout, if there's a KERP in place, I encourage the Board or the compensation committee to immediately consider modification of the KERP to address a lot of the things that Scott was just talking about. What this question raises is a lot of different issues. If you've got a troubled company, typically when people come to see me, management has already started to change. There is a perception that changes were needed in order to reposition the direction of the company, and those sorts of things have started, and if you're bringing on new management the factors that go into the compensation structure are going to be different than the ones that historically existed. I recommend to my clients across the board that they not be KERPs, because KERPs are literally, as Kathy pointed out, unenforceable in a bankruptcy setting. So if you end up in a Chapter 11, you've got a real problem on your hands. I tend to think that a well-constructed compensation program for management that's based on a set of incentives that is created pre-petition, is more likely to be approved by a bankruptcy judge after the petition is filed than one that you are fashioning in a hurry after you file, or a plan that's been in place for a long time historically. There, you're looking at parameters in the plan that are going to be problematic from a Bankruptcy Court and creditor perspective, whereas if it was fashioned in the month or two prior to the filing of the case, it's more likely to have the kinds of incentive provisions in it that are going to be approved. So I would say, from my perspective, once a company starts into a downturn of one kind or another and it's perceived to be something beyond cyclical downturns that all companies go through, then the compensation committee should begin to consider modification of its compensation program to avoid KERPs.

**Bonneville:** I definitely have seen KERPs becoming less popular, though they can be very effective in very specific situations. In fact, we just put one in place for an organization that was doing a merger where one of the companies was going to end up being much smaller. In that particular situation there was a need to keep some key people, very critical people, in critical areas, for a specified period of time, and the KERP was the best way to do that. You were going to keep those people through the merger, and it was important enough to keep them. I think our role in that process is to help them design a plan that's not just for everybody, but that you're making sure that you are targeting the people that are the most critical to keep during that period.

**Feraro:** And that's a great point to look at. The KERP, the key employee retention, is based on the fact that these employees are required for the ongoing success of the organization. That without their contributions, it's likely that the organization would fail or would not come out of bankruptcy. Those are the kinds of difficult decisions often that you're having to make when putting something like a KERP in place. And the other idea being that the KERP, during a bankruptcy situation, is looked at more negatively, but if you're not in a bankruptcy per se, and you're in a troubled situation, you're getting through a difficult transition or period of time, using a KERP for those key individuals, for that retention incentive, may be advisable.

**Meyer:** I would just like to put a footnote on what I said in light of what Kathy and Scott just said. The problem that we face in Chapter 11 cases is the situation where it is anticipated that the company will be sold, and that 60, 90 or 120 days down the road there will be a change of control. And you've got people who are not going to survive the change in control, but you absolutely need them to remain in order to

maintain the value of the business pending the transaction. Almost always, these transaction documents have adjusters in the purchase price for the changes in value of the business between the time the due diligence is done and the purchase agreement is signed, and the time the transaction closes. I do think that it's wise and possible to construct what are essentially KERPs to retain those people, based on the maintenance or improvement in the value of the business between the time that the company is offered, or the deal is signed with the investment banker, and the time that the transaction closes. If everything goes well, that's one of the most difficult times to manage a company – when a sale is pending and people are uncertain about whether or not they're going to be employed by the surviving company or the acquiring company. So I would put that footnote on what I said before about KERPs.

**Rosenbaum:** Okay, and Mike you can combine that, I trust, with more of a classic retention program as long as it's broad based. In other words, if it's smaller and broad based, you can combine the incentive portion with a retention program.

**Meyer:** Yes. Let me say that bankruptcy judges in particular, and creditors generally, are much more interested in approving plans that give the same sort of protection to employees down the line as they give to management. That is to say, somebody who has worked at a company for 20 or 30 years and is uncertain about whether he or she is going to retain their job in circumstances like this, if they are also protected in some fashion by the plan, it is much more likely to be approved.

**Feraro:** And I think as you said, this is sort of like Sarbanes-Oxley. On the corporate side, there was some overreaction to some of the really high profile bankruptcies earlier in this decade, like Enron. I think the management there walked away with over \$100 million in retention payments that were approved, and that was sort of the way you did it, because the idea was you had to keep the business together. But there was no incentive component, and I think the PR of that was horrible. I think that even if there weren't a law, there would be fallout that would cause bankruptcy judges to be less likely to approve something that's pure retention.

**Meyer:** That's right. Although I have to say that for a period earlier in this decade it did seem like KERPs that predated a Chapter 11 filing were being routinely approved early on in a bankruptcy case, the first week, before the creditors or other parties in interest even had any opportunity to comment. They were just being signed off on.

**Rosenbaum:** Right. And obviously the landscape has changed. A case that I referred to earlier [involving a large public company that went through Chapter 11] was at that time. I hadn't been familiar with those agreements, but all of a sudden here they were, they were in place. We just reviewed them, they got signed, and the securities lawyers had to describe them in SEC filings.

Mike, maybe go back to how Bankruptcy Courts have interpreted the limitations. You were saying that there is a set of programs that you can do that are still going to have a retention sort of impact, but I know that people have been trying different things, and there's sort of a line of cases, isn't there?

**Meyer:** Yes. There is. It's been interesting - the way the bankruptcy courts have dealt with the limitations. If the plan is a retention plan, or if it's a severance plan, if it's denominated as such, the bar is so high on getting it approved that it's virtually impossible. So that what's ended up happening is, these plans that have a retention or a severance aspect to them have been typically re-characterized as incentive plans of one kind or another. The courts have said, this plan clearly has a retention aspect to it, but it also has an incentive aspect to it, and therefore I'm going to test it under the other provision. The way the law was passed, there's a special provision for retention or severance plans, and then there's a catch-all provision that relates to all other plans, under which the court has to determine whether the plan is justified under the facts and circumstances of the case. Obviously, this gives the court a lot of discretion on what the court approves. Compare that to the limitations on retention plans, for instance. The only way that a retention plan for a given executive can be approved in a bankruptcy case is, that executive must not only be looking for a job but has to have a job offer, and there has to be proof that that executive is critical not only to the reorganization of the company but to its survival. I mean it's a ridiculously high standard. Whereas, if you're going in to approve a plan that has incentive aspects to, the courts have

said, well this is predominately an incentive plan, and I'm therefore going to determine that under the facts and circumstances of this case, it's justified. So that's what the courts have done. They have used what some would call a loophole, but its an exception to the restrictive rules that apply to retention plans and severance plans.

**Bonneville:** And as I mentioned before, the most difficult thing about the incentive plan is coming up with measures that are achievable, and being able to predict financial performance and what is achievable – setting those goals. In my experience, because of the limitations, what companies in Chapter 11 have had to rely on is equity compensation upon emergence. Executives and management, just like shareholders, typically get their equity holdings wiped out by the bankruptcy. So new equity plans are put in place, and typically what they do is they set aside a percentage of the company to grant, and the bulk of it is granted at emergence. Typically, what I'd say, and particularly in the airline industry, is a mix of full value stock, like restricted shares and stock options. You're trying to balance the fact that in the short- to mid-term, that there may not be any value created so the stock options may not be worth anything for a while. The restricted shares provide that retention and motivation in the short- to mid-term.

**Rosenbaum:** So it's a lot of the same issues that any compensation committee is going to face, but sometimes in a real pressure-cooker situation, either in bankruptcy or leading up to bankruptcy. And maybe we could talk about the role or position of the compensation committee and the Board, both in making compensation decisions and dealing with shifts in management. Scott, what words to the wise do you have for compensation committees in dealing with these situations?

**Feraro:** Well, it's being prepared to make the decisions necessary to not only get plans approved and metrics accepted, but making sure that they're aligning with the short and long-term viability of the business. For instance, if you are a troubled financial institution, short of bankruptcy, there are probably regulatory agencies that have put you under some level of restriction, up to and including a cease and desist or a seizure. Along that road there are certain requirements that have to be met around performance – who is driving the ship, and how well they are aligned with the turnaround goals of your institution. So I have a client currently who has a situation where, as a requirement of the FDIC and state regulators, the current head of operations of that bank is being required to leave the organization, or not be directly involved with the day-to-day operations of the bank. The relationships that current CEO has with Board members are significant and long standing. So, this decision is as much an emotional one for the Board as it is an operational one. They are considering leaving that executive in place and attempting to make the turnaround with that same leader in charge of operations of the bank. Probably not the most beneficial decision for the bank, but those are the kinds of decisions that we're looking at boards to make, that are for the best interest of the institution, as opposed to any one individual or small group of individuals in the organization.

**Rosenbaum:** Mike, maybe you could comment just on reorganizing companies, especially when boards have to make hard decisions about management, and maybe the Board has to deal with its own role in the trouble the company is in.

**Meyer:** That's right. That raises all sorts of questions, Marty. Typically the first thing that I talk about with a Board of Directors and, to some extent, with the compensation committee when I get engaged, is that under Minnesota law, as well as the law of most states around the country, the obligations of boards of directors change. The obligations change when you get into an insolvency situation or a threatened insolvency situation, and the Board needs to readjust its thinking about whose interests it is representing. Typically there is a duty of one kind or another that arises to the creditors of the company, and the perspective audience for the Board's decisions is different than it has historically been. And decisions about whether or not to retain executives can become much more difficult under those circumstances, because the historical bonds that exist between a Board and executive management may be strained to the point where even consideration of them is inappropriate. And that obviously ripples through to executive compensation decisions as time goes on. Probably the most difficult situation that I get involved in is the one where there has been a decline in a business, and any neutral outsider would conclude that it's most likely the result of mismanagement. Many times that's not the case, by the way. But in some cases it is. The problems will be laid directly at the feet of management, and many times

with decisions that have been made with the Board's full approval. And getting the atmosphere changed so that the direction of the company can be changed is difficult in those circumstances, many times requiring an outside consultant to come in, and changes happen as a result of that.

**Bonneville:** Yes, we're frequently brought in as a consultant, particularly to provide information on benchmarking what other companies in similar situations have done. I think as Scott mentioned, it is often difficult for the compensation committee to look at what situation are we in, how is this different, and what do we need to do differently to compensate our executives because of the situation. I think the normal practice is to look at what their peer group is doing, but that doesn't necessarily work in this situation because their peers may be in a completely different financial situation. And so, what we can bring is information on what has worked with companies in a similar turnaround situation, and it can be very different types of comp programs than normal course.

**Rosenbaum:** Okay. Well another question that we discussed before, and I was talking to Mike about, was what impact bankruptcy laws have on pre-bankruptcy companies that may need to show executives the door because they certainly have rights under their existing employment agreements, benefit plans, programs. How does the prospect of a possible Chapter 11 filing impact some of those negotiations?

**Meyer:** Well, the general answer to that question is that it makes those negotiations easier. And the reason that it does is that a Chapter 11 debtor has the right to reject contracts and leases, but let's focus on contracts that continue to have life. Let's take, as an example, a five-year employment contract with a chief executive that the company wants to move out. Once the Chapter 11 case is filed, the debtor can reject that contract, and the damages that the employee can claim as a result of rejection of the contract are limited under the Bankruptcy Code to essentially accrued and unpaid compensation at the time of rejection of the contract, plus one year's compensation thereafter. And that tool that a Chapter 11 debtor has, typically makes the negotiations with an outgoing executive a whole lot easier in terms of what's going to get paid at the time the severance occurs. So those are the facts.

**Rosenbaum:** Yes, and I'd assume though that, as a company is approaching a decision point or its business is in trouble, just having that knowledge is helpful in giving the departing executive some perspective on the facts. The parties don't necessarily know the likelihood of a Chapter 11, but just the fact that if a company does go in this direction, and that may be a fairly good likelihood, then the landscape changes. Therefore, you need to play ball, basically.

**Meyer:** That's right, and the measure of the damages in a bankruptcy case is just the starting point for the negotiations, typically. If the company is looking at making a cash payment to an executive who has an employment contract at the time of severance, that cash payment can many times be less than that year's compensation. If a bankruptcy case is imminent, that one year's compensation is the size of the claim in the case, and that claim is going to be treated like every other claim in the bankruptcy case, and maybe it only ends up getting some cents on the dollar, 50, 40, 60, whatever ends up happening in the case. So the executive who is going to walk away with a check at the time of severance may very well take substantially less than one year's compensation in consideration of termination of the contract.

**Rosenbaum:** Okay, well the landscape also changes in non-bankruptcy situations with regulated industries, and we included in the materials an article about Fannie Mae and Freddie Mac and the bailout. In connection with that, there is some regulatory authority for denying any severance or separation payments, and maybe, Scott, you could comment on that a little bit. As a result of the current turmoil, and there's an election coming up, there certainly is a big debate in government about further regulation. The whole area of regulating severance payments is in the mix.

**Feraro:** Sure, and granted, in an election year everything is going to be heightened, and emotions are going to be more significant and the risk of overregulation is significant and the fact that the abuses potentially, or the mismanagement has been equally significant. So the idea that non-performance-based rewards are going to be limited, is likely going to continue. It behooves organizations who are at risk, and finding that the decisions they made were probably not the most prudent, leading up to the environment we're currently in, to have those performance measures in place so that the rewards aren't looked at as

only severance or retention-based. Another recognition is that the talent required to get someone out of a troubled situation or out of a bankruptcy will look very different than what got the organization into that situation. So, understanding what those talent profiles look like and what the value of those executives or organizational leaders are in the marketplace, and what will be valuable to them is probably very different than what may you're going to be offering one of the executives that were in place at the time of the downturn.

**Rosenbaum:** We'll maybe get into more general topics, and we only have a few minutes left, so I want to make sure I get to a couple of the non-bankruptcy, non-bailout questions and lessons learned. I'll start with Scott and Kathy on setting incentive goals for companies that may be in a more troubled situation, maybe the stock is down. So you need to find new ways to give people incentives, and maybe dealing specifically with the situation a lot of companies are in where they're halfway through, or a good way through, the current year. Maybe things aren't working out, if it's a calendar fiscal year, and at this point everybody knows they're not going to meet their goals. How does a compensation committee, management and consultants, how do you adjust the course? Start with Kathy.

**Bonneville:** Yes, it's certainly a topic of mine with a lot of companies right now. And I think most companies are reluctant to change their annual incentive plan, the plan that they've had in place for a while, which typically is centered around profitability. Most plans have some measure of profitability in them, and you have plans that haven't been paying out for a number of years. I encourage companies to take a look at those plans and maybe look at measures besides financial measures, things like strategic goals, really other things that the management team needs to focus on to turn around the company, leave other plans in place like the equity that was really intended to be a long-term incentive, and not be the short-term incentive that it's ended up being in the last few years.

**Meyer:** I think that's right. The non-financial goals, although often looked at as more subjective and more difficult to manage and measure the result of, there are specific shorter term and longer-term, non-financial goals that could be set, and I think around the signing of agreements, entering into contracts, vendor negotiations, the specific execution of behavioral drivers within the operating units of the executives that are on the hook for the viability of the business, all of those are fair game for integration into executive and non-executive compensation. Drawing the line between those and, ultimately, the financial drivers of the business is important, but it doesn't necessarily have to be the financial result that we're basing the reward on.

**Bonneville:** The other thing that we're really seeing, I think, a lot more companies including in their plan are peer measures. That's become pretty prevalent, particularly in Europe. You're seeing measures like total shareholder return relative to your peer group, or cash flow relative to your peer group. Using peer measures to offset things outside of the management team's control that would impact the whole industry. In Europe you're seeing a move to putting performance-based, long-term incentive, or equity based, plans in place, so performance shares has become pretty prevalent and their metric of preference is total shareholder return. So those shares only vest if your total shareholder return is within, say, the top quartile of your peer group. It's an interesting twist, and I think you're going to see a lot more of those types of plans in place here in the United States.

**Rosenbaum:** It's interesting to look at international standards more too, not just in a troubled company situation, but I think in so many ways businesses have, in everything from accounting standards to other business methods. People are going to be looking more internationally as businesses become more international.

Mike, why don't you weigh in about just setting goals either in or outside of bankruptcy, but the difficulty of adjusting course and stepping back for a minute, looking at what's the right measure and then getting people to buy into it.

**Meyer:** Well, I don't disagree with anything that Scott and Kathy said. To me, it's just a matter of being able to rationally explain the plan to the court and to the creditors in a way that makes sense to them, where they can perceive the value that's going to be achieved by the company as a whole, in the event

that these incentives are paid. If you can make that connection, you can get there, and, like I said before, it's a lot easier to make with new management than it is to make with management that's perceived to have gotten you into the situation that you're in today.

**Bonneville:** I just thought of another effective strategy, particularly with the other constituents. We do work in industries that are heavily unionized, and they're certainly an interested party and have become, I think, much more sophisticated in how executive compensation programs work. One effective strategy I have seen is companies putting in place incentive plans for the non-executives, including employees under collectively-bargained arrangements that have ties to the management incentive plan. So things like a profit sharing plan or succession plan, that have the same financial measures as the management incentive plan. Some companies will go as far as to say that there won't be any payout under the management incentive plan unless the non-management, the broad based, profit sharing plan pays out. And so I think that, besides putting everybody on the same incentive plan, it gives the employees the sense that they're being measured and rewarded for the same thing that the management team is.

**Rosenbaum:** And listened to, and that's what my employment law partners are telling me is important. Another change in the wind is the Employee Free Choice Act that is making its way through Congress, and may or may not be signed by the next president in some form. It is going to make it much easier, if adopted in some form, for various groups of employees to unionize. So for management, if they're looking to avoid dealing with a union, if that's part of management's goal, one way to help do that is to be proactive now, in making sure that employees know that they're being listened to and that they're being valued. Something like what Kathy is saying in terms of, "you'll have some incentive compensation with the same incentive goals that management has, and you'll be treated in the same way". Management won't just get this rich package while you just work by the hour and then get laid off. That can be an effective way to make the employees feel that they don't need a union to be heard by management.

One other point about what the panelists were saying. In choosing different incentive goals, or measures, other than very mechanical metrics, a lot of those formula-driven plans, especially annual incentive plans, are driven by another reform measure from the 1990s – Section 162(m), the million dollar cap on executive pay. The way to avoid the million dollar cap, as companies have found, is to have a very formula-driven incentive plan. It has to be something that is objective, where someone looking at the goals that were set by the compensation committee in the first three months of the year, and then looking at the company's results, just looking at a spreadsheet, will be able to determine on an objective basis exactly what the incentive bonus should be. Some of the measures Scott was talking about are things that probably wouldn't meet that test, and certainly changing the goals in mid-stream, if the company is in some trouble and needs to reset the goal, is going to blow the million dollar cap. But I think more and more companies are going to consider that maybe that's a price that has to be paid, and I've seen this in the last few months in proxy statements – in other words, it's cheaper to lose the tax deduction on some component of the compensation than it is to give management the wrong incentive.

So, with just a couple of minutes on underwater stock options, I'll just mention the article that's in the course materials, and I think that does a pretty good job of laying out some of the alternatives. Basically, companies generally don't just change the price of the options. Most companies will opt to do an exchange program. With a public company, that means that they have to file a tender offer statement with the SEC. It's a pain, but it's not that tough to do, and we've certainly worked with clients who have done that in recent years. Most companies now are actually doing a program where the employees give up their options and get a restricted stock grant for a much lower number of shares, resulting in less dilution for the company. Then if the stock fluctuates, if it goes down a little bit further, the employees still keep most of the value of the grant – they are not left with zero. Usually vesting starts again. So, I give up my option, and I get something that has real value now, where I as an employee maybe thought that my option has no value, why should it motivate me. Also, the exchange has the retention component of starting a new vesting period. So really in some ways everybody wins, but these are certainly very unpopular still with ISS/RiskMetrics, and with the institutional shareholder groups, who will basically categorize anything being given in exchange for an option as being a repricing, and, changing the rules of the game. Therefore they'll basically vote against any equity plan for a period of time after that. That

doesn't get a happy reception, but, again, sometimes companies feel that they need to do something to keep their people in the door and keep them motivated.

I want to thank the panelists very much, and want to thank all of you for listening. I'll see you at the next NASPP Chapter meeting which is on December 4. We'll send out more e-mail notices. And I hope that people are considering the NASPP National Annual Conference, October 22 through 24 in New Orleans. Many of us from the Twin Cities are headed down there, and it's a great conference. So, thank you very much for listening.